QUOTED COMPANIES ALLIANCE

UHY Hacker Young
Chartered Accountants

Corporate Governance Behaviour Review 2014

Quoted Companies Alliance & UHY Hacker Young

This is the second Corporate Governance Behaviour Review of small and mid-size quoted companies.

The top five governance reporting tips

Link strategy and corporate governance

Understand your risks and explain how they link to strategy

Focus on the audit committee report

Describe board evaluation procedures

Explain why each director is on the board

2014 has seen further change in the corporate governance landscape, with the introduction of the new Strategic Report, changes to the UK Corporate Governance Code and the new requirement for AIM companies to disclose their corporate governance arrangements on their websites. The results of this year's Corporate Governance Behaviour Review indicate that these changes are still bedding in.

We benchmarked corporate governance disclosures made by 100 small and mid-size quoted companies on the Main List, AIM and ISDX against the minimum disclosures outlined in the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies (the QCA Code). The sample is made up of a randomly selected set of companies which are different from those used in our 2013 analysis. In a similar way to last year, we shared the results of our analysis with a group of institutional investors at a roundtable discussion and have drawn on their input in determining our latest top five corporate governance reporting tips.

Overall, the level of corporate governance disclosure amongst small and mid-size quoted companies remains similar to our findings from 2013. Companies continue to show variable levels of disclosure, improving slightly in some areas, such as audit committee and risk management disclosures, and regressing in others – most noticeably in the posting of voting decisions at general meetings on corporate websites.

The results continue to indicate that small and mid-size quoted companies seem to struggle with:

- linking the application of corporate governance to strategy;
- making board evaluation disclosures (albeit there has been a slight improvement this year); and
- describing the role of external advisers in the boardroom.

We hope that this report will help quoted company directors improve the communication of their corporate governance arrangements and how they support long term growth. Good governance becomes part of the fundamental identity of those companies which truly espouse it: it is something to be lived by an organisation and thereby is inherently linked into its strategy for sustainable growth. As such, good corporate governance represents a foundation upon which new, sustainable growth in the post-financial crisis market will be delivered.

EXECUTIVE SUMMARY

IMPACT OF CHANGES TO THE GOVERNANCE LANDSCAPE

The three most significant external corporate governance changes during 2014 have been:

- narrative reporting and the introduction of the Strategic Report;
- the changes to the UK Corporate Governance Code (effective 1 October 2014); and
- the London Stock Exchange amending AIM Rule 26, requiring AIM companies to disclose the corporate governance standards they apply.

Narrative reporting

It remains too early to fully understand the effect of the recent narrative reporting changes, including the introduction of the Strategic Report (effective 1 April 2014). The objective of these changes is to ensure that companies provide a link between strategy and performance and, to achieve this, it is important for companies to have governance arrangements that are appropriate to their business. In addition, larger companies must give meaningful narrative on the impact of their corporate operations on the environment, the communities in which they operate and their employees.

UK Code revisions

The recent revisions to the UK Corporate Governance Code focus on the issues of remuneration, risk management and going concern. Whilst the changes only became effective on 1 October 2014, and therefore will not have impacted directly on the disclosures analysed in this review, these themes have been a focus of attention for the last few years and the legislative changes requiring a binding shareholder vote on remuneration policy are already in place. Furthermore, the Financial Reporting Council is emphasising the need for a positive tone to be set from the top: this should start to have an impact on reporting in 2015.

AIM rule 26

AIM companies now need to disclose on their corporate website details of the corporate governance code that they have decided to apply, how they comply with that code or, if no code has been adopted, explain their current corporate governance arrangements. This rule change only took effect from 11 August 2014 and many AIM companies are yet to apply the change, so we are waiting to see both what the effect will be and how the London Stock Exchange will encourage better disclosure by companies through this change. However, this new requirement represents an important step in the right direction.

SIGNIFICANT THEMES

The most important theme arising from our work is that the 2014 annual reports and websites which were reviewed mostly showed no significant changes (up or down) from the data set reviewed in 2013; the areas of high and low disclosure have remained broadly similar.

Failure to effectively link governance with strategy

Similar to last year, companies struggle to explain effectively the link between their governance arrangements and their long term success and strategy for growth. Only one company reviewed this year disclosed this. We recognise that this linkage is difficult to achieve – as do institutional investors. Nonetheless, institutional investors continually tell us that this is a key disclosure and something that they look for. As companies become more acquainted with the new Strategic Report, we believe that this could lead to improvement in this area.

Greater understanding of board evaluation

It is encouraging that the level of disclosure on board evaluation procedures seems to be increasing, almost doubling to 27% compared to only 14% in 2013. Companies have improved their disclosures of how evaluation procedures have evolved from previous years, from 2% in 2013 to 10% this year. Investors want to see companies assessing the quality of directors and the skills that directors have – all in an effort to address any skills gap on the board.

However, we found that the number of companies disclosing the identity of the directors, their roles and committee membership has fallen to 79% from 93% in 2013. Similarly, 73% (compared to 91% in 2013) disclose the relevant skills and experience that the executive directors and non-executive directors bring to the board. Investors tell us that these disclosures are paramount in helping them understand why certain directors are on the board together with board evaluation procedures more generally.

Reporting of audit issues and risk

Companies seem to be addressing the reporting of audit issues and risk, thereby encouraging an open and transparent dialogue in relation to issues that arise as a result of the audit, consequently improving the trust between companies and investors.

36% of companies (up from 20% in 2013) include details of the significant issues considered by the audit committee in relation to the financial statements and how these issues were addressed. 28% of companies (up from 17% in 2013) disclose how the audit committee also focused on risk (where there is no designated risk committee). However, there is room for further improvement as only a minority of companies include these disclosures in the audit committee report. The Quoted Companies Alliance's recently published Audit Committee Guide for Small and Mid-Size Quoted Companies includes a section on the audit committee report and provides best practice guidance on what companies should focus on in this report.

Companies' disclosures on risk and risk management have also improved over the last year. 89% of companies (up from 73% in 2013) include a summary of the systems of risk management and internal control and the uncertainties facing the business, whilst just over half (51% - up from 38% in 2013) provide an explanation of how risks align with the strategy of the company.

Publication of general meeting results

AIM companies are generally not obliged to announce general meeting voting decisions (whether on their corporate website or through a Regulated Information Service (RIS) announcement). Companies listed on the Main Market must publish the results through a RIS. Whilst this is simple and easy to do, only 33% of companies post voting decisions on corporate websites – notably lower than the 65% that disclosed it in 2013. This opens up an unnecessary risk for those companies, is a ground for criticism and leaves scope for manipulation. Investors have indicated that this is something that they would expect to see and so companies should focus on improving disclosure in this area.

APPROACH TO DISCLOSURES

In our discussions with a range of investors in small and mid-size quoted companies, it was clear that there are a few areas where investors expect to see higher levels of meaningful disclosure.

More generally, investors tell us that there are two overriding principles that companies should follow when producing their governance disclosures:

Confidently tell your story and don't hide things

Companies should write the annual report and accounts in their own voice, conveying a clear and honest message to investors. Companies should be forward-looking and explain what has changed from the previous year and what key challenges are coming up in the next year. Most importantly, do not hide non-compliance. Investors prefer for companies to highlight this and explain what they do instead. They want to know why that alternative practice is in their best interests.

Avoid boilerplate and immaterial disclosures

Investors can tell when companies include standard-wording in their disclosures – they read a significant number of annual reports and accounts and can see trends. Corporate governance is about moving beyond compliance to explain what you do and why you do it in your own words.

GOVERNANCE REPORTING TIPS

The top five specific disclosures that companies should focus on in 2015 are:

Link strategy and corporate governance

Investors want to see companies clearly articulating their strategy (Disclosure 20 of the QCA Code) and explaining how the application of their chosen corporate governance code supports the company's long term success and strategy for growth (Disclosure 3 of the QCA Code). Whilst everyone accepts that this is difficult to do, it is key to ensuring that a company's corporate governance structures and processes are appropriate and helping to deliver long term growth and increasing shareholder value.

Understand your risks and explain how they link to strategy

Similarly, companies should focus on articulating their risks without the use of boilerplate text. They should explain how their risks impact on the company's strategy and link into key performance indicators (KPIs), remuneration policies and corporate social responsibility activities (Disclosure 16 of the QCA Code). Investors have told us that they are keen to see companies thinking about risks and KPIs over the long term, moving beyond just a one-year time period and potentially reporting on these over a longer time frame.

Focus on the audit committee report

There have been a number of regulatory changes in this area over the past few years, as well as enhanced attention generally on audit quality and risk management following the financial crisis. It should come as little surprise that investors are keen to see companies clearly articulating the significant issues considered by the audit committee in relation to the financial statements and how these were dealt with (Disclosure 4 of the QCA Code).

Describe board evaluation procedures

Investors want to see companies assessing the quality of directors and ensuring that boards have, both today and in the future, the appropriate skills to deliver growth. Therefore, as more small and mid-size quoted companies continue to understand the benefits of board evaluation (Disclosures 17 and 18 of the QCA Code), companies should focus on improving their disclosures, ensuring that they not only explain the performance procedures, but also the result of the evaluation, consideration of succession issues both within the board and senior management and actions taken.

Explain why each director is on the board

Companies often highlight each director on the board and include a biography in the annual report and accounts. However, investors are most interested in why the director is on the board and the specific skills he or she brings to the table (Disclosure 9 of the QCA Code). Do not just assume that people can figure this out from a biography which is probably already in the public domain.

OUR ANALYSIS

This section details our measure of corporate governance behaviour by showing the percentage of the sample of 100 companies that included the minimum disclosures of the QCA Code in their annual report and accounts and/or corporate websites.

CHAIRMAN'S GOVERNANCE REPORT

No	Disclosure	2014	2013
1	The narrative reporting of the company should include a report by the Chairman of how the QCA Code is applied.	14%	10%
2	There was reference to 'the Code' (unspecified).	69%	71%
3	The report should include how such application supports the company's long term success and strategy for growth.	1%	3%

AUDIT COMMITTEE REPORT

No	Disclosure	2014	2013
4	An audit committee report should explain the major tasks undertaken and demonstrate an independent oversight of both management and external auditors. It should include details of the significant issues considered by the committee in relation to the financial statements and how these issues were addressed.	36%	20%
5	There should be an explanation to shareholders of how audit objectivity and independence is safeguarded, particularly if the auditor provides significant non-audit services.	35%	31%
6	The audit committee also acts as the committee focused on risk if there is no designated risk committee, and as such the committee should indicate how this role has been undertaken.	28%	17%

REMUNERATION COMMITTEE REPORT

No	Disclosure	2014	2013
7	A remuneration committee report should explain how the company's remuneration policy and practice align with the company's strategy.	61%	68%

DETAILS OF DIRECTORS

No	Disclosure	2014	2013
8	The identity of all the directors, their roles and committee memberships must be disclosed.	79%	93%

RELEVANT SKILLS AND EXPERIENCE

No	Disclosure	2014	2013
9	The relevant skills and experience that the executive and non-executive directors bring to the board should be described.	73%	91%

INDEPENDENT DIRECTORS

No	Disclosure	2014	2013
10	Those directors considered to be independent should be identified. The reasons for their independence should be explained and particular attention given to circumstances where the status of independence may be impaired.	33%	43%

Investors want to see companies assessing the quality of directors and the skills their directors have.

COMMITTEES

No	Disclosure	2014	2013
11	There should be a brief description of the work of each board committee and its role.	75%	95%
12	Committee responsibility and accountability should be explained.	67%	87%

MEETINGS AND ATTENDANCE RECORDS

No	Disclosure	2014	2013
13	There should be disclosure of the number of meetings during the year of the board and of the committees.	57%	70%
14	The attendance records of each director should be provided.	51%	67%

RISK MANAGEMENT AND INTERNAL CONTROL

No	Disclosure	2014	2013
15	There should be a summary of the systems of risk management and internal control and the uncertainties facing the business.	89%	73%
16	An explanation should be provided of how risks align with the strategy of the company, as well as linking into key performance indicators, remuneration policies and corporate responsibility activities.	51%	38%

PERFORMANCE EVALUATION

No	Disclosure	2014	2013
17	There should be a description of the performance evaluation procedures for each director, the whole board and each committee focusing on their objectives and outcomes.	27%	14%
18	Include a summary of how evaluation procedures have evolved from the previous years, the result of the evaluation and action taken or planned as a result.	10%	2%

INFORMATION SUMMARY

No	Disclosure	2014	2013
19	There should be a summary of information received by the board and by individual committees.	2%	5%

SUMMARY OF STRATEGY

No	Disclosure	2014	2013
20	There should be a clear articulation of the strategy of the company.	41%	56%

DESCRIPTION OF ROLES

No	Disclosure	2014	2013
21	There should be a description of the roles and responsibilities of the chairman, chief executive and, if applicable, the senior independent director.	48%	65%

Investors have indicated that the results of shareholder voting are something they would expect to see and so companies should focus on improving disclosure in this area.

MATTERS RESERVED FOR THE BOARD

No	Disclosure	2014	2013
22	There should be a list of the types of decisions reserved for the board.	39%	32%

NON-EXECUTIVE APPOINTMENT TERMS

No	Disclosure	2014	2013
23	Terms and conditions of appointment of non-executive directors should be stated.	4%	12%

TERMS OF REFERENCE: AUDIT AND REMUNERATION COMMITTEES

No	Disclosure	2014	2013
24	Terms of reference of the audit committee and the remuneration committee should be included.	42%	41%

TERMS OF REFERENCE: NOMINATION COMMITTEE

No	Disclosure	2014	2013
25	Where there is a nomination committee, the terms of reference of the nomination committee should be included. If there is no separate nomination committee, there should be an explanation of the processes by which the whole board determines nomination and senior appointment matters.	33%	29%

ROLE OF EXTERNAL AND INTERNAL ADVISORS

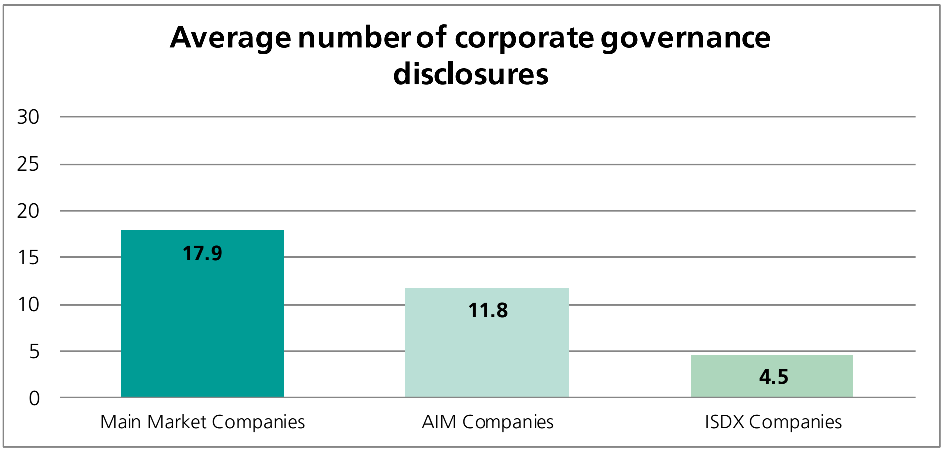
No	Disclosure	2014	2013
26	An explanation should be given of the role of any external advisers to the board or its committees (in particular, the remuneration committee) and any internal advisory responsibilities, such as the roles performed by the company secretary and the senior independent director in advising and supporting the chairman. Where the company secretary is also a director, the company should provide an explanation for this.	4%	6%

PUBLISHED MATERIAL

No	Disclosure	2014	2013
27	The Annual Report and other governance-related material should be on the website.	100%	98%
28	Notices of all general meetings over the last three years should be on the website.	53%	63%

RESULTS OF SHAREHOLDER VOTING

No	Disclosure	2014	2013
29	Voting decisions should be posted on the company website.	33%	65%
30	Where votes at a general meeting are by show of hands, the votes by proxy received by the company, including abstentions or votes withheld, should be reposted as soon as practical after the meeting. Where votes are conducted on a poll, the actual votes, including votes withheld or abstentions, should be reposted as soon as practical after the poll.	18%	65%



Market	Number of companies in the sample	Average number of disclosures	Minimum number of disclosures	Maximum number of disclosures
Main Market companies	35	17.9	3	25
AIM companies	61	11.8	3	27
ISDX companies	4	4.5	2	7

METHODOLOGY

The analysis was conducted on 100 annual reports and accounts and corporate websites of small and mid-size companies with equity securities admitted to trading on a London market (the Main Market of the London Stock Exchange, AIM and the ISDX Growth Market) across all sectors in July and August 2014. Note that the sample of companies analysed in 2014 is different to those analysed in 2013.

UHY Hacker Young assessed these companies' annual reports and accounts and governance disclosures on their corporate websites against the minimum disclosures of the Quoted Companies Alliance Corporate Governance Code for Small and Mid-Size Quoted Companies 2013 (the QCA Code).

The assessment was completed on a straightforward binary measure: did the company disclose the minimum disclosures of the QCA Code or not. We did not seek to judge the qualitative nature of the disclosure.

The conclusions of this exercise were then presented at a roundtable discussion in October 2014 with institutional investors who provided feedback on the aspects they consider to be significant.

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